

**SENATE APPROPRIATIONS SUBCOMMITTEE ON FISCAL  
OVERSIGHT AND BONDED INDEBTEDNESS**

**Informational Hearing – February 7, 2007**

**State Treasurer Bill Lockyer**

**Opening Remarks**

Thanks, Mr. Chairman and members.

Capital investments can leave great legacies, and build great futures.

Here in California, we have a lot of investing, a lot of work, to do if we want to build for our children and grandchildren the kind of California they deserve -- the kind of California we all want.

At the polling places last November, the people showed they're up to the challenge of constructing a better California.

In approving \$42.7 billion in infrastructure bond spending, they launched our state on an unprecedented - and daring - capital investment program. Conceptually, it will provide the infrastructure used by our grandchildren.

To fulfill its promise, however, we will need to use financing strategies attuned to today's capital markets.

We are moving into a new era of public finance, far bigger and more complex than even a few years ago.

California now is a major player in an increasingly global municipal securities marketplace.

By the time we have issued all general obligation bonds currently authorized, we will rank just behind Italy and ahead of such countries as Mexico, Brazil and Sweden among the world's largest, sovereign bond issuers.

Increasingly, individual investors are buying municipal bonds directly and not just through mutual funds. We need to consider if there are ways we can make it easier for such individuals to buy our bonds.

In addition, we have seen a tremendous increase in the role of hedge funds, arbitrageurs and other non-traditional buyers. In fact, the last time the state sold bonds, a \$1 billion issue last November, these investors bought 60% of the offering.

All this presents California with tremendous opportunities, but also substantial challenges, as we move forward with our infrastructure investments.

We need to recognize the changing realities of the marketplace, and our place in that marketplace. And we must give ourselves the tools we need to operate in the marketplace with maximum flexibility, so we can minimize our cost and risk.

At the same time, we must assure the people that we, as their stewards, are making prudent investments and protecting the public purse.

To provide this assurance, the Controller and I recommend a citizens' commission to provide transparency and accountability for the expenditure of bond money approved by the voters for infrastructure projects.

Our proposal rests on a simple premise: In making their historic investment last November, the voters placed great trust in their government leaders, but they did not make a leap of blind faith.

We in government owe it to them to provide strong, independent, citizen-based oversight of infrastructure bond spending to ensure their money is spent wisely, efficiently and in a way that provides the greatest benefit to communities across California.

As we look to the future, California's needs are great:

- By 2050 there will be nearly 55 million Californians – today's California population (in early 2007) is more than 37 million.
- A 1999 study by the California Transportation Commission (1999) surveyed state, regional, and local transportation agencies for their *unfunded* 10-year needs for system rehabilitation, operations, and high-priority expansion projects.
- The combined total for transportation improvements was between \$107 billion and \$117 billion, three-quarters for system expansion and one-quarter for rehabilitation or retrofit of existing assets.
- Beyond transportation, the state will need billions more for housing, environmental protection, water system improvement, parks and schools. To give you just a few specifics, to accommodate project growth, we will need to:
  - ✓ Build 220,000 new homes every year.
  - ✓ Construct 19 new classrooms every day for five years.
  - ✓ Hire 220,000 new teachers in 10 years.

- ✓ And find a way to deliver another 200,000 acre-feet of water to supply Central and Southern California.

The \$43 billion the voters approved last November and the \$43 billion the Governor has proposed in his fiscal 2007-08 budget may seem like a lot of money. But, combined, they're only a good first step.

So, before I answer questions, I want to leave you with these thoughts:

We have hundreds of billions of dollars in infrastructure investment needs. The Governor's own infrastructure plan anticipates "investing" \$223 billion between this year and 2015-16.

But we should not be afraid to make the necessary investments.

We have the capacity, it's good for the economy because it provides good jobs for working folks, and it makes California a better place in which to live and do business.

We don't need to impose artificial and unnecessary constraints on ourselves. We can't afford to do that and we shouldn't.

But we do have to be mindful, as we make the investments we need to secure our future, that in doing so, we will become an increasingly prominent player in an increasingly globalized market.

To accomplish our investment goals, California will have to be nimble. Our watchwords must be flexibility, affordability and security.

# **SENATE APPROPRIATIONS SUBCOMMITTEE ON FISCAL OVERSIGHT AND BONDED INDEBTEDNESS**

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## **Key Issues and Points**

### **➤ CURRENT DEBT**

#### **Outstanding Debt**

The state has \$54.8 billion of debt outstanding to be paid from the general fund:

- General Obligation Bonds - \$37.7 billion
- Lease Revenue Bonds - \$7.6 billion
- Economic Recovery Bonds (ERBs) - \$9.5 billion

#### **Debt to be Issued**

The state currently has the following in bond debt authorized (by voters or Legislature) but not yet issued:

- General Obligation Bonds - \$67.8 billion
- Lease Revenue Bonds – \$3.1 billion
- Economic Recovery Bonds - \$3.7 billion

#### **Issuance Frequency**

Over the past five years, the State has issued:

- General obligation bonds 4 to 5 times per year.
- Lease revenue bonds 3 to 4 time per year.

The frequency is limited by:

- Blackout periods – 4 to 5 months out of the year – when conflicts between the state’s requirement to provide all material information to the market, on one hand, and the state’s possession of information that must be kept private as the California develops its budget, on the other hand, prohibit us from issuing bonds.
- The need to give the market time to absorb new bond issues before the state makes the next offering.

- The Treasurer's Office is looking into shortening the blackout periods so the state can schedule more bond issues each year.

### **Issuance Size**

Over the last five years:

- Average size of general obligation bond sales – approximately \$1.2 billion.
- Average size of lease revenue bonds sales – approximately \$219 million.

With the new bonds to issue:

- Annual issuance is likely to double.
- The average size is likely to double, too, unless we can reduce the blackout periods.

## **➤ DEBT AFFORDABILITY**

### **General Points**

There is no single “right” amount of debt that is affordable.

Debt burden is not a major factor determining the state's credit rating.

Ten states, each with higher ratings, have a greater amount of debt as a percent of personal income.

*Instead, “affordability” is a policy judgment about the state's willingness to pay for capital projects given our other program expenses and the revenue structure we choose.*

- Too much debt – if debt service grows to consume revenues needed for necessary or critical public service programs.
- Too little debt – if we fail to fund essential capital projects that are necessary for our economy or that, if not funded, would impose greater costs later (like fixing a roof before it leaks).

Rating agencies respond favorably to governments that have well thought-out and reasonable capital and debt-affordability plans.

### **The Changing Market**

Traditional investors have included insurance companies, mutual funds, investment funds, investment banks, trust departments, corporations, individual investors and money market funds.

The top 30 institutional investors in the state's general obligation bonds hold about 25 percent of all outstanding bonds.

The top five investors, who alone own about 9 percent of the state's bonds, are:

- AIG Global Investment Group, Inc.
- Franklin Templeton Investments
- The Vanguard Group Inc.
- Nuveen Asset Management
- Fidelity Management & Research Co.

***The investor base is evolving into a more sophisticated market with non-traditional institutional investors such as hedge funds, arbitrageurs and tender option bond programs playing an increasing role.***

- They buy very large amounts of bonds, often more than \$100 million at a time.
- In today's market, they are willing to purchase the state's bonds at lower interest rates than traditional buyers are demanding.
- Rather than being motivated just by the interest rate California pays, they buy bonds based on factors such as the shape of the yield curve, the duration of the state's bonds, the option value in the call and how those factors compare to other securities in the worldwide market.

***California is selling its bonds to an international market and must have the ability to meet the demands of that market if we want to get the lowest interest rate and save the taxpayers' money.***

## ➤ **BOND RATING AND DEBT SERVICE COST**

### **Improving Our Rating**

California's general obligation bonds are currently rated A+/A1/A+ from Standard & Poor's, Moody's and Fitch.

- Only Louisiana has a lower rating.

Eliminating the state's structural budget deficit is important (but maybe not sufficient) to get an upgrade.

- The rating agencies believe progress has been made, but the structural deficit still remains.
- The Legislature should solve the deficit and resist the temptation to borrow in the future to balance the budget.
- The Legislature should budget to build up the state's general fund reserves.

***There are structural impediments in our governance and budgeting that will continue to hold down California's rating.***

- Because of budget constraints imposed by initiative and constitutional amendments over the last two decades, rating agencies tell us California starts at a disadvantage relative to other states.
- Since the rating agencies assign ratings, in part, by comparing one state to another, California is faced with serious challenges.
- But the state can do better, and policymakers ought to consider some of the factors that influence rating analysts' view of California:
  - ✓ A highly volatile and uncertain revenue structure based largely on the personal income tax.
    - ***Standard & Poor's reported earlier this week, "The main budget risk remains the state's poor record of revenue forecasting." S&P noted that in the last four years, the difference between revenues estimated in the governor's budget and actual year revenues have differed, on average, by 8 percent.***
  - ✓ The requirement for a 2/3 majority to approve a budget and raise taxes.
  - ✓ The initiative process.
  - ✓ Budgetary mandates such as Prop. 98, Prop. 42 and Prop. 1A.
  - ✓ No process for mid-year budget corrections.
- It's important to note that the state's rating is not held down by the amount of debt to be issued – even with the Governor's proposed new Strategic Growth Plan (SGP II) – if the state can demonstrate the value of the investments and how they will be repaid.

**Savings from Improved Rating**

The difference in interest rates for bonds in the various rating categories is called the "credit spread."

Spreads are currently compressed due to a lot of demand in the market and the overall low level of interest rates.

Given today's market conditions, the state's borrowing costs on new bonds would drop by zero to five basis points if California's rating was upgraded one notch to AA-/Aa3/AA-.

- ***Each one-basis-point difference in yield would save about \$2.2 million in debt service costs for every \$1 billion borrowed for 30 years.***



While a better credit rating might bring a small benefit today, it is still very important to try to improve our credit rating.

- The credit spread could widen in the future, producing more savings from a higher rating.
- As we issue more debt, and we have to attract new buyers to our bonds, a strong credit rating will be very helpful.
- Perhaps as important as any savings we will enjoy, improvement in California's bond ratings may significantly improve our ability to sell more bonds. Given the magnitude of our needs, greater opportunity to issue bonds provides an excellent reason to pursue better ratings by removing impediments, including the structural deficit.

### **Structuring Sales to Improve Marketability, Terms and Interest Rates**

The state will be issuing a lot more debt – and selling that debt into a new market where investors are driven by factors not seen before.

Policymakers need to look at the general bond law and other statutes that govern how California issues bonds.

*Lockyer plans to come to the Legislature, following careful study, and propose measures that will allow California to meet the challenges and opportunities presented by the changing marketplace.*

Ideas worth studying include:

- **New credit**
  - ✓ With the economic recovery bonds, the state created what the capital markets see as a new credit.
  - ✓ The state looks at it no differently than general obligation bonds, since it is paid from general fund revenues.
  - ✓ But a portion of the state's sales tax is dedicated to the bonds.
  - ✓ This gives it a higher rating – S&P just confirmed its AA+ rating – while the general obligation bonds have a rating of A+.
  - ✓ It also means that investors and bond insurers, who are limited in how much exposure they can have to any one credit, can buy the economic recovery bonds even though they are limited in their ability to buy more general obligation bonds.
  - ✓ Extending this to infrastructure bonds will give California more capacity and enable the state to sell bonds at lower interest rates.
- **Looking at our debt as part of a portfolio**
  - ✓ In the next five years, California will be issuing general obligation bonds at least 25 to 30 times, and offering at least \$40 billion to \$50 billion of debt.

- ✓ California is one of the world's largest users of the capital market to borrow funds.
- ✓ The state should develop an overall strategy for debt issuance rather than look at each bond issue individually.
- ✓ *The state's goal should be to have a portfolio of outstanding debt that imposes low cost and risk on the state, and affords the state maximum flexibility.*
- ✓ That means taking advantage of market opportunities and financial products that the corporate world has employed to great benefit for many years.
- **Selling bonds in a new way**
  - ✓ With new buyers in the market and a large amount of bonds to issue, California can explore new ways to sell bonds.
    - It might be possible to sell the state's bonds on a stock exchange, providing investors with great liquidity. This could lower costs.
    - The state also could explore selling bonds directly to investors over the Internet. This might encourage more California individuals to buy our bonds.
- **Offering new products**
  - ✓ We sell a limited range of products: fixed rate bonds and variable rate bonds.
  - ✓ The municipal bond market encompasses many other products that, if used, could expand the universe of buyers for the state's bonds.
    - Many of these products involve interest rate swaps used by both public and private issuers.
      - The Legislature provided authority to use swaps with respect to the 2006 bond authorizations.
      - The Treasurer's Office will begin to explore and assess the use of swaps.
  - ✓ *Lockyer will come to the Legislature and propose any further measures needed to take advantage of opportunities to reduce cost and risk, and increase flexibility.*

## ➤ **INVESTOR CONFIDENCE**

### **State Finances**

The state provides detailed information on its operation and finances to the investment community.

For every bond sale, the state issues an “Official Statement,” which includes a lengthy appendix about the state’s finances. For the last sale, the appendix was 89 pages long.

The Treasurer’s Office posts on its web site a substantial amount of information about California’s finances. The information is regularly and frequently updated.

The Treasurer’s Office is evaluating whether it should provide more financial information, and will be working with the Department of Finance to implement any needed improvements.

### **Debt Affordability Report**

The Debt Affordability Report, issued by the Treasurer’s Office, provides important information about the state’s debt.

The usefulness of the report could be enhanced by providing a more thorough analysis of issues related to state bond issues, including:

- Impact on the state budget.
- Impact on the economy.
- Such an affordability analysis can be a useful tool to help policymakers identify appropriate levels of borrowing and make decisions about future capital projects.

## ➤ **STATE-LOCAL GOVERNMENT PARTNERSHIP**

### **Coordinating Building or Issuances?**

In California, local governments and the state have not extensively coordinated their capital or debt plans.

- The state and local governments should better coordinate the building of infrastructure for which they share responsibility.
  - ✓ In the case of roads and housing, California already has in place mechanisms for making sound, coordinated decisions.
  - ✓ We have less well-articulated coordination mechanisms for other shared responsibilities.

- The question of whether the state and local governments should better coordinate bond sales needs more study.
  - ✓ With the state intending to issue large amounts of debt, it is possible that, on occasion, the state could be competing with local governments for the same investors.
  - ✓ The state must inform local issuers of its issuance plans, so local governments can plan their sales calendar to maximize market attention.

# **SENATE APPROPRIATIONS SUBCOMMITTEE ON FISCAL OVERSIGHT AND BONDED INDEBTEDNESS**

**Informational Hearing – February 7, 2007**

## **State Treasurer Bill Lockyer and State Controller Chiang Citizens' Bond Oversight Commission**

### **➤ ROLE**

Monitor state general fund-backed bond expenditures approved by voters or Legislature.

Collect information on expenditures and bond-financed projects, and regularly disseminate the information to the public in a widespread, easily-understood manner.

### **➤ RESPONSIBILITIES AND DUTIES**

Inform the public about the state's progress in delivering projects from the bond expenditures voters have authorized.

Track expenditures project-by-project to determine whether they are being delivered on time and on budget.

Identify whether taxpayer money is misspent due to waste or inefficiency.

Publish findings on a web site so members of the public can monitor the status of projects in their communities.

Hold hearings and issue reports about the pace and efficiency of project delivery, and make recommendations to policymakers.

Through the State Controller, audit projects and expenditures.

Would *not* have any role in deciding which projects to fund or setting priorities for allocation of bond funds.

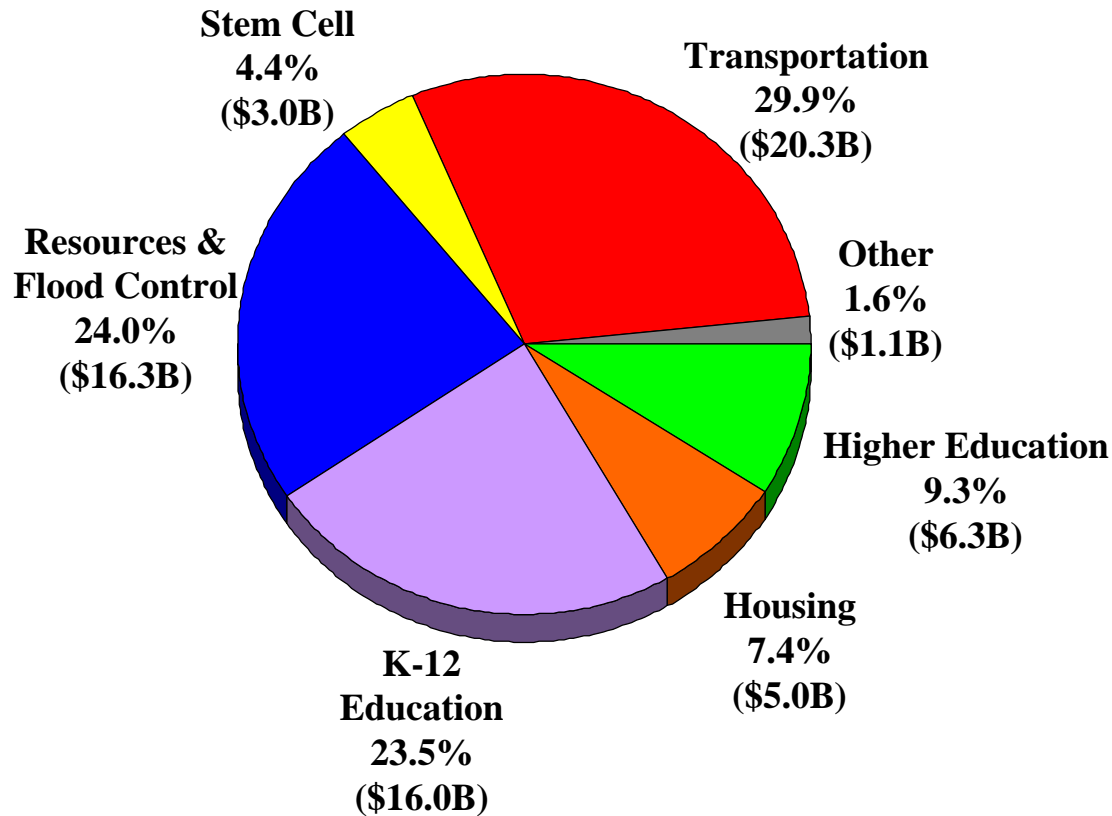
### **➤ COMPOSITION**

Compared to other bond oversight entities, the Commission would have stronger credibility as an independent body because it would be comprised of people not in state government.

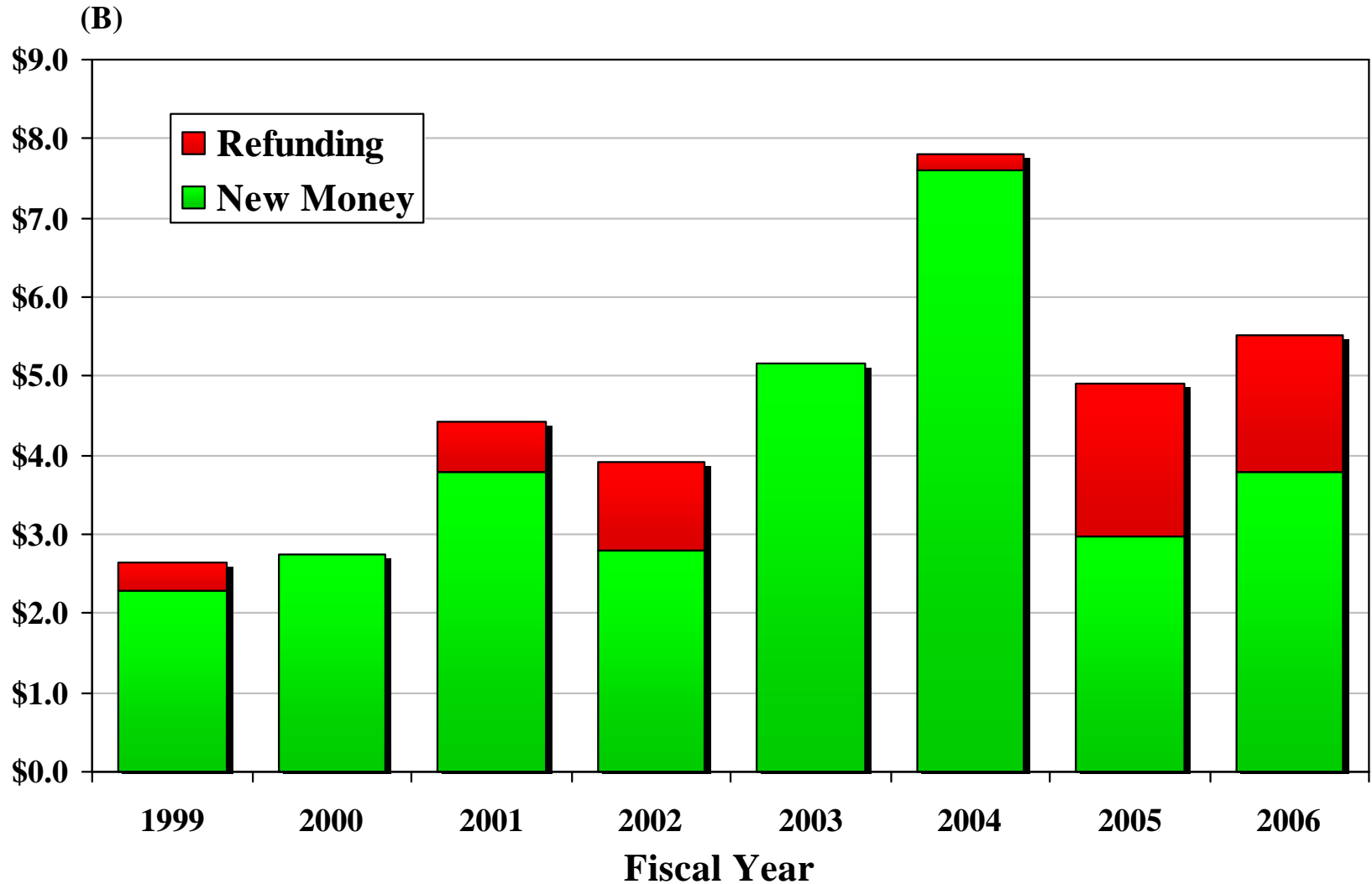
11 members: State Treasurer; State Controller; Director of Finance; eight private citizens (two each appointed by Treasurer, Controller, Governor, Assembly Speaker and Senate Rules Committee).

Four private citizens would have experience in public infrastructure and financing; the other four would have no relationship to the public infrastructure or financing community.

## Authorized but Unissued G.O. Bonds by Program Area

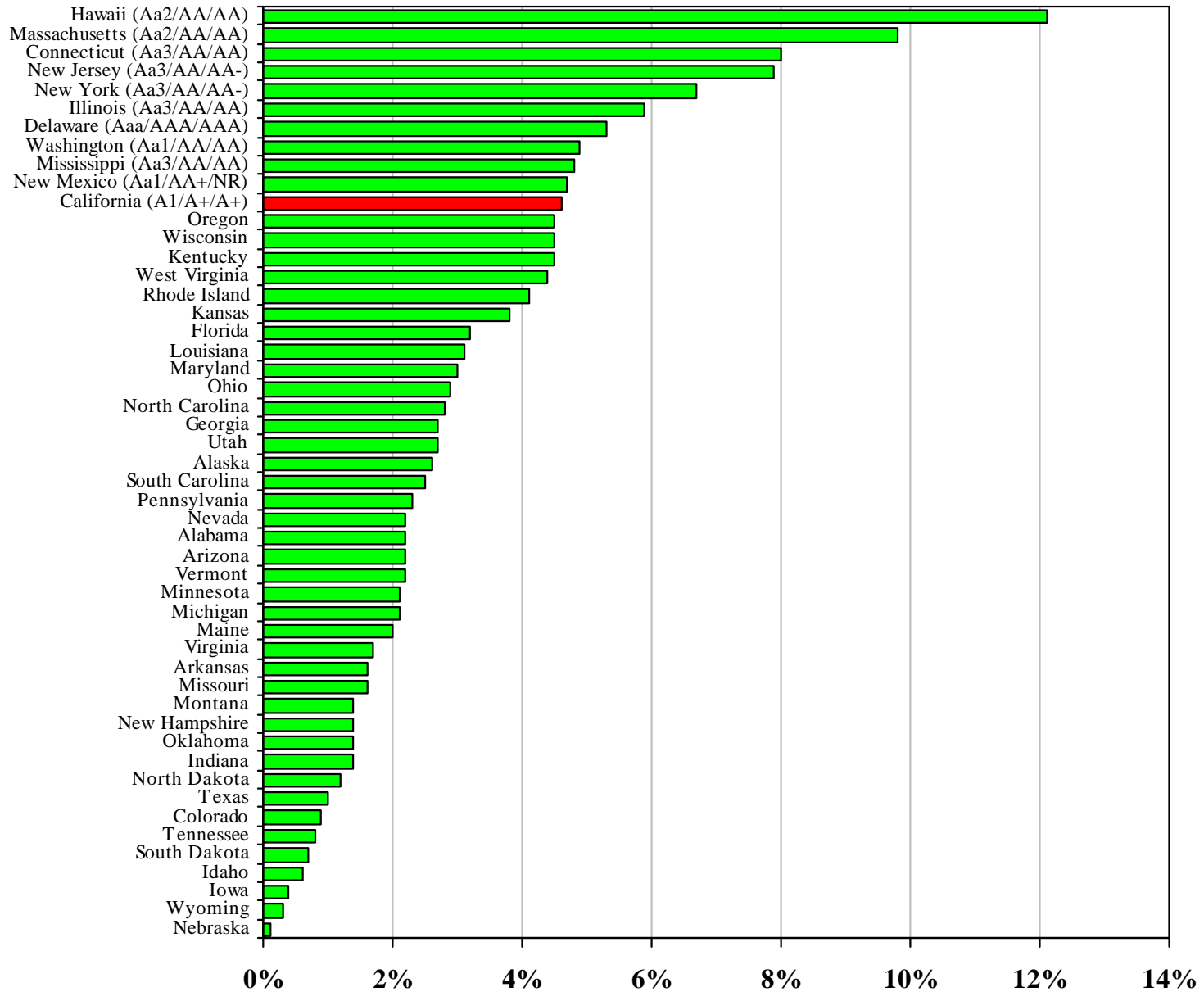


## Total G.O. Bond Sales Per Fiscal Year



Note: Excludes self-supporting G.O. Bonds and Economic Recovery Bonds.

# State-by-State Comparison of Net Tax-Supported Debt as Percentage of Personal Income

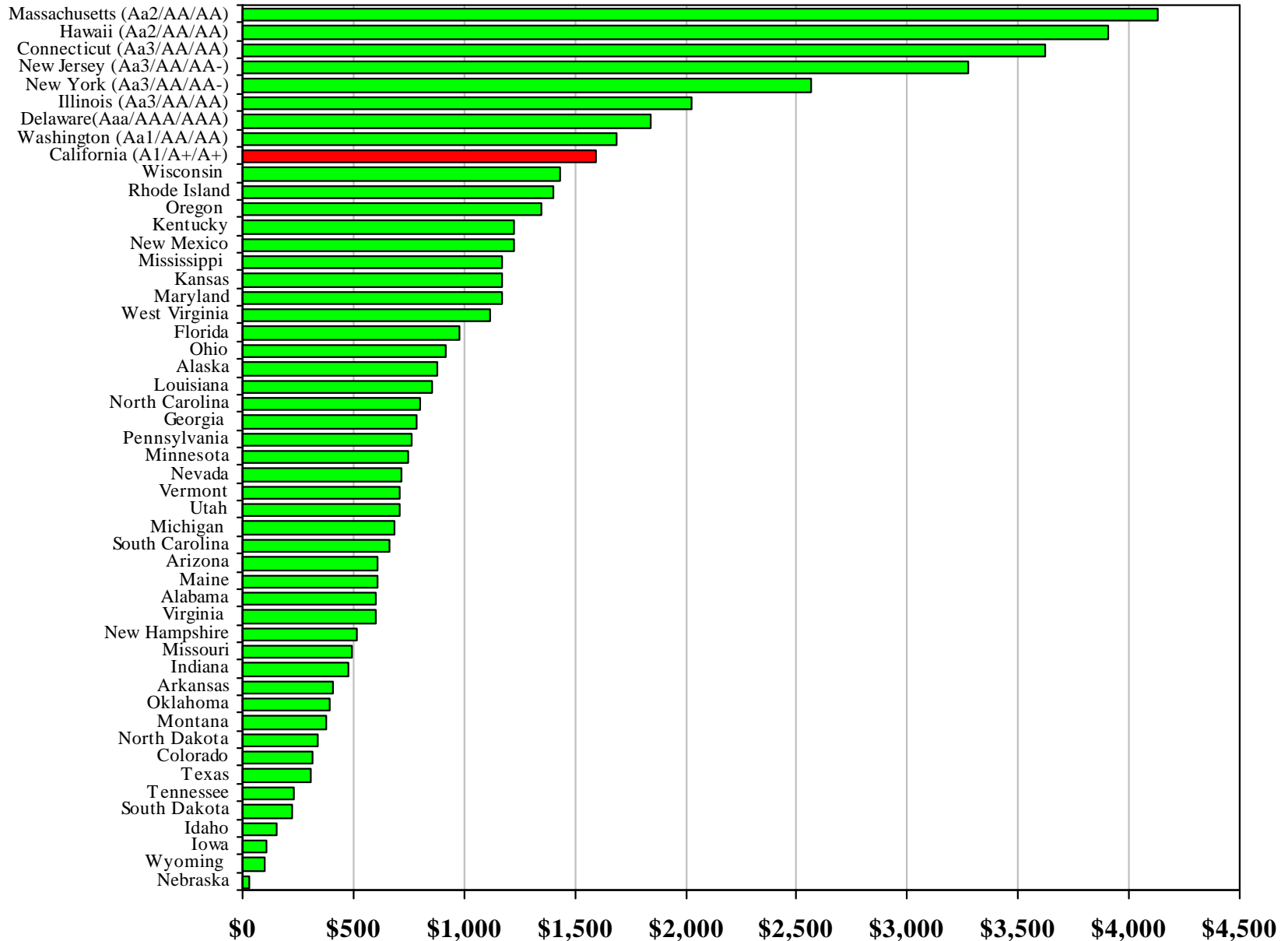


Note: Includes all G.O. Bonds, Lease Revenue Bonds and Economic Recovery Bonds.

Source: Moody's Investors Service, 2006 State Debt Medians, dated April 2006



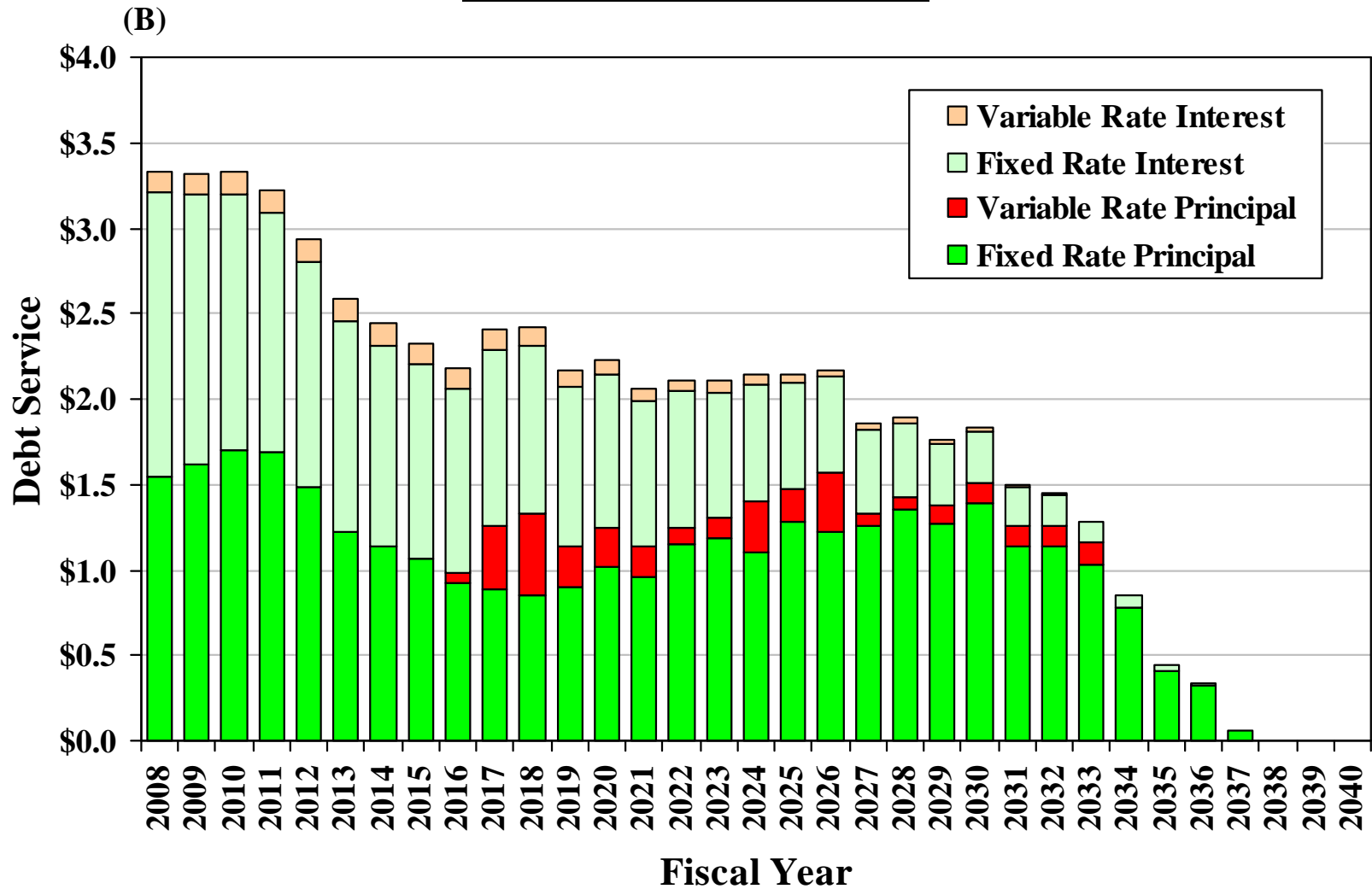
# State-by-State Comparison of Net Tax-Supported Debt Per Capita



Note: Includes all G.O. Bonds, Lease Revenue Bonds and Economic Recovery Bonds.

Source: Moody's Investors Service, 2006 State Debt Medians, dated April 2006

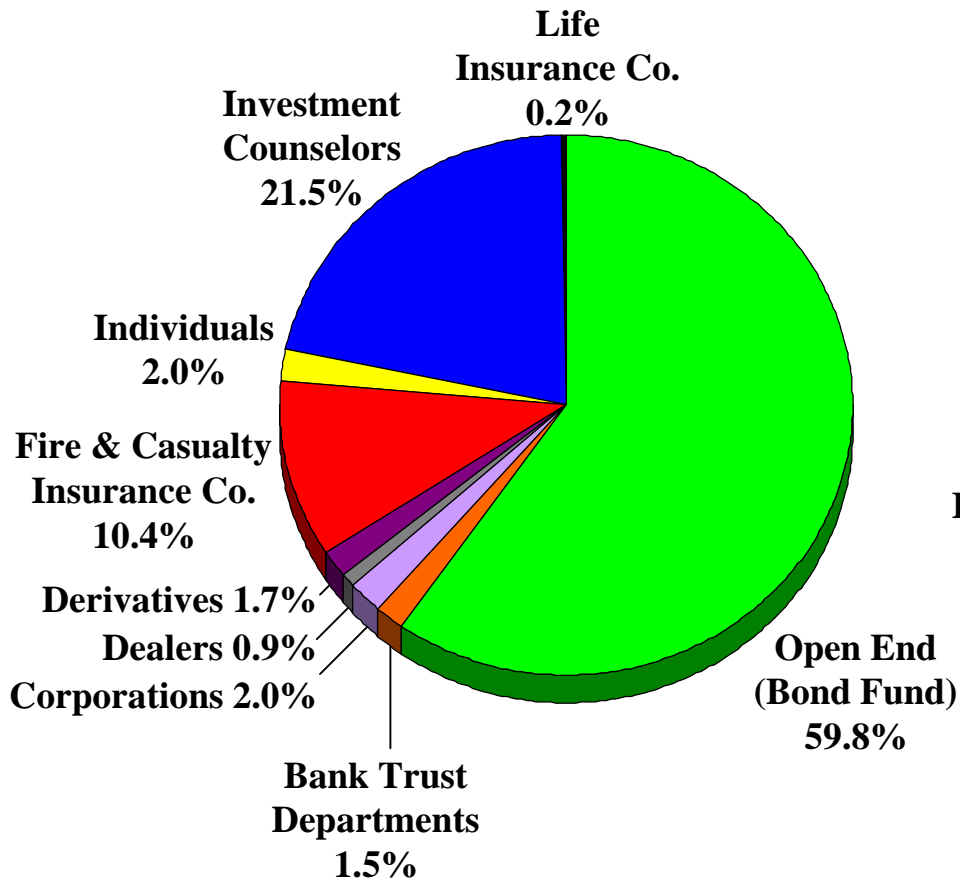
## G.O. Bond Debt Service



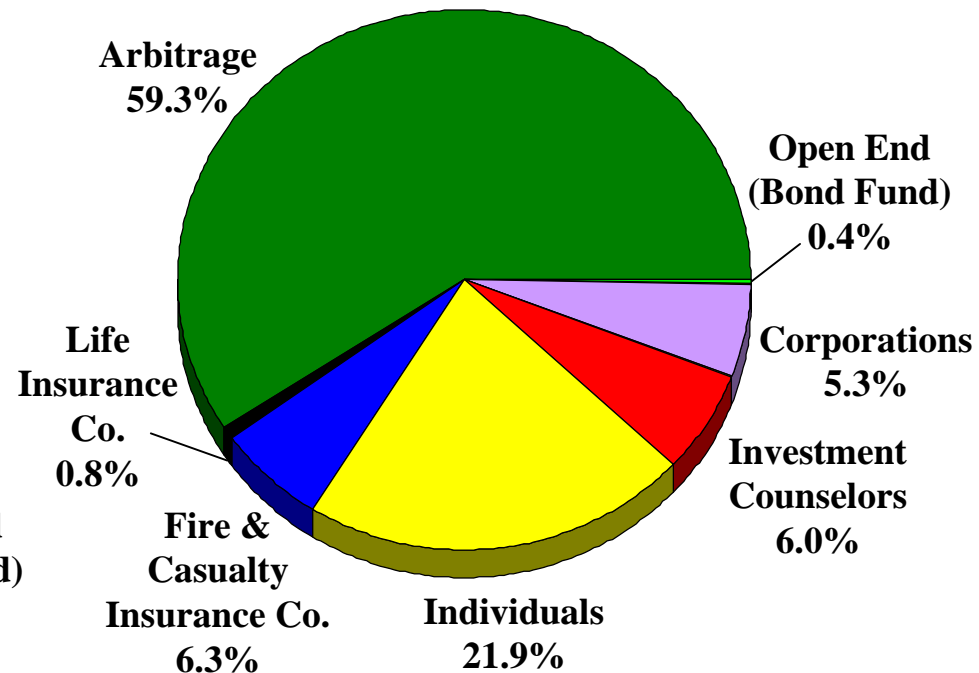
Note: As a January 1, 2007. Excludes self-supporting G.O. Bonds and Economic Recovery Bonds.

# Investors in the State's G.O. bonds have shifted significantly since 2004

**February 2004**  
**\$2.00B Negotiated Sale**



**November 2006**  
**\$1.07B Competitive Sale**



# **Largest U.S. Tax-Exempt Bond Sales**

- Since 2000, the State's competitive G.O. Bond sales have represented 9 of the 10 largest tax-exempt competitive sales

Largest Tax-Exempt Competitive Long-Term Deals			
Sale Date	Issuer	Par (\$mm)	Issue Description
9/8/2005	California	1,146.4	Var Purp GO Refunding Bonds
3/13/2002	California	1,105.0	GO Refunding Bonds
12/7/2005	California	1,032.5	Various Purp GO Refunding Bonds
6/14/2006	California	1,014.1	Various Purpose GO & Ref Bonds
6/12/2001	California	1,000.0	General Obligation Bonds
10/30/2001	California	1,000.0	General Obligation Bonds
2/20/2002	California	1,000.0	General Obligation Bonds
2/16/2005	California	944.1	GO Construction & GO Ref Bonds
9/7/2005	Georgia	931.8	GO & GO Refunding Bonds
6/16/2005	California	925.1	Var Pur GO & GO Ref Bonds

- Tax-exempt negotiated sales have been significantly higher

Largest Negotiated, Fixed-Rate, Tax-Exempt Long Term Financings				
Sale Date	Issuer	State	Par (\$mm)	Issue Description
5/6/2004	California	CA	6,921.515	Economic Recovery Bonds
11/7/2002	California Dept of Wtr Resources	CA	6,313.500	Power Supply Revenue Bonds
1/24/2007	NJ Tobacco Settlement Fin Corp	NJ	3,622.208	Tobacco Settlement Senior Bonds
7/28/2005	Golden State Tobacco Sec Corp	CA	3,140.563	Tobacco Settlement Asset Backed
5/9/2002	Metropolitan Transportation Auth	NY	2,894.185	Transportation Revenue Ref Bonds
5/23/2006	New Jersey Trans Trust Fund Au	NJ	2,696.037	Transportation System Bonds
1/16/2003	Golden State Tobacco Sec Corp	CA	2,625.000	Tobacco Settlement Bonds
9/25/2003	Golden State Tobacco Sec Corp	CA	2,572.285	Tobacco Settlement Bonds
9/19/2002	Triborough Bridge & Tunnel Auth	NY	2,157.065	General Revenue Refunding Bonds
2/21/2003	Los Angeles USD	CA	2,100.000	General Obligation Bonds

➤ Since 2000, the largest tax-exempt negotiated fixed rate sale was \$6.9 billion